A Review of Fiduciary Duties in California and Delaware Corporations

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Introduction

The legal community and the press have focused much attention on the responsibilities of corporate officers and directors under the federal Sarbanes Oxley Act. In addition, the daily press has been replete with examples such as the Enron litigation demonstrating the federal criminalization of corporate law. The advantages and disadvantages of the increasing federalization of the duties owed in the corporate context have been, and will continue to be, a source of debate.[2] However, the business practitioner, and particularly, the business litigator in California, will most often look to the principles of state fiduciary duty law to evaluate potential claims within the corporate context. Given the historical predilection for incorporation in Delaware, the California lawyer practicing in this area should have familiarity with both Delaware and California law. This article seeks to present a brief summary of fiduciary duties in the corporate context under the laws of both states.

The corporation presents potential fiduciary duty issues for shareholders, directors, officers, employees, and promoters. It is often stated that shareholders do not owe a fiduciary duty in their capacity solely as shareholders to either the corporation or other shareholders. (See *Jones v. H.F. Ahmanson & Co.* (1969) 1 Cal.3d 93.) The *Jones* case did identify certain circumstances in which a fiduciary duty may be imposed under California law: when a majority shareholder usurps a corporate opportunity from, or otherwise harms, the minority shareholder. (*Id.* at p. 108.; *Miles, Inc. v. Scripps Clinic and Research Foundation* (S.D. Cal. 1993) 810 F.Supp. 1091, 1099 (applying California law, "The general rule of limited liability of corporations is that shareholders do not owe each other a fiduciary duty.); *Ivanhoe Partners v. Newmont Min. Corp.* (Del. 1987) 535 A.2d 1334, 1344 (Under Delaware law a shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation.)

A careful analysis suggests that one must consider whether the corporation is closely held and whether the shareholder is a controlling shareholder. In both California and Delaware, as in other jurisdictions, it has been held that the controlling shareholder owes a fiduciary duty to both the corporation and the minority shareholders.

In closely held corporations, there are two principal views of the fiduciary duty of shareholders. Massachusetts and a number of other jurisdictions have adopted what has been characterized, probably improperly, as the "majority" view. This view holds that, at least in a closely held corporation, *all* officers, directors, and shareholders are fiduciaries of each other and, in that capacity, owe each other a heightened fiduciary duty, similar to that which partners owe each other in a partnership.

Delaware follows what has been characterized as the "minority" view that controlling shareholders, at least in closely held corporations, like officers and directors, owe fiduciary duties to the corporation. (See, e.g., *Hollinger International, Inc. v. Black* (Del. 2004) 844 A. 2d 1022, 1061, fn. 83; *In re Summit Metal, Inc.* (D.Del. 2004) Westlaw 1812700, *12.) A shareholder need not own a majority of the corporation's share to be a "controlling shareholder." Thus, even if a shareholder owns less than 50% of the outstanding shares, if that shareholder exercises domination through actual control of corporate conduct, the shareholder can be deemed a controlling shareholder. (See *Citron v. Fairchild Camera & Instrument Corp.* (Del. 1989) 569 A.2d 53, 70; *Ivanhoe Partners v. Newmont Mining Corp.* (Del. 1987) 535 A.2d 1334, 1344.) The duties for controlling shareholders as expressed in at least some Delaware cases appear to be owed to the corporation only; California cases hold that the duties are owed to both the corporation and other shareholders. The controlling shareholder in a Delaware corporation, unlike a partner in a general partnership who owes a fiduciary duty to all other partners, does not owe a fiduciary to the other shareholders. Under Delaware law, however, a controlling shareholder may vote his shares in his own self-interest even if that interest is contrary to the corporation's best interest. (*Thorpe, et al. v. CERBCO, etc.* (Del. 1996) 676 A.2d 436 (controlling shareholders have a right to vote as shareholders in their own self-interest).)

In both Delaware and California, the fiduciary duties owed by a controlling shareholder include the duties of loyalty and care. The application of those duties in Delaware are often presented in the context of alleged self-dealing transactions (i.e. where the controlling shareholder is effectively on both sides of the transaction). Self-dealing is not per se invalid under Delaware law, but rather is subject to the entire fairness test. By being on both sides of the transaction, the controlling shareholder bears the burden of proving the entire

fairness of the transaction. (*Kahn v. Tremont, Corp.* (D.Del. 1997) 694 A.2d 422, 428; *Lynch Communication Sys. Inc.* (D.Del. 1994) 638 A.2d 110, 1115.) Delaware courts also apply the entire fairness test wherever the fiduciary will receive a financial benefit from the transaction at issue that is not equally shared by all the stockholders. (*In re LNR Property* (Del. Ch. 2005) 896 A.2d 169, 175.) It has been held that the disparity must be more than a *de minimus* departure from equal treatment. (*McGowan v. Ferro* (D.Del. 2004) 859 A.2d 1012, 1029.)

Entire fairness has two components: fair dealing and fair price. Fair dealing includes such factors as when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how approvals were obtained. Fair price relates to the economic and financial consideration for the deals. (See *Weinberger v. UOP, Inc.* (D.Del. 1983) 457 A.2d 701703.)

California case law provides authority indicating that a controlling shareholder owes fiduciary duties to both the corporation and the minority shareholders. (See, e.g., *Stephenson v. Dreyer,* (Cal. 1997) 16 Cal.4th 1167, 1178 (stating that controlling shareholder's fiduciary duties include good faith, inherent fairness and equal opportunity for minority shareholders); *Jones v. Ahmanson & Co.* (Cal. 1969) 460 P.2d 464, 471 (holding that any use of the corporation or controlling power must benefit all shareholders equally).) In *Stephenson,* a minority shareholder and former employee brought an action against the majority stockholder of a closely held corporation and two of its officers and directors for breach of fiduciary duty and misuse of corporate assets. The plaintiff was a party to a buy-sell agreement giving the corporation the right (and obligation) to repurchase the shares of the minority shareholder on the termination of his employment. The precise issue presented was whether the agreement, on its face, implied an intention to deny the minority shareholder his rights post-employment but before the shares were transferred. The California Supreme Court held it did not. The court explained that corporate shareholders have valuable property rights including the right to dividends voted by the boards. The court concluded that, since the plaintiff was the only minority shareholder, the directors and the majority shareholders had fiduciary duties to the minority shareholders:

> Majority shareholders may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority. Any use to which they put the corporation or their power to control the corporation must benefit all shareholders proportionately and must not conflict with the proper conduct of the corporation's business." [*Jones v. H.F. Ahmanson & Co.* (1969) 1 Cal.3d 93, 108] adopted "the comprehensive rule of good faith and inherent fairness to the minority in any transaction where control of the corporation is material" (*id.* at p. 112), and declared broadly that "[t]he rule applies alike to officers, directors, and controlling shareholders in the exercise of powers that are theirs by virtue of their position and to transactions wherein controlling shareholders seek to gain an advantage in the sale or transfer or use of their controlling block of shares." (*Id.* at p. 110.)
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> *Stephenson v. Dreyer* (1997) 14 Cal. 4th at 1178.

The *Stephenson* court quoted *Jones v. Ahmanson & Co., supra,* 460 P.2d 464 at p. 110, holding that majority shareholders may not use their power to control corporate activities to benefit themselves alone or to the detriment of the minority and that any use of the power to control the corporation must benefit the shareholders, "proportionately and must not conflict with the proper conduct of the corporation's business." (*Jones. v. Ahmanson & Co., supra,* 1 Cal.3d at p. 108.)

In *Jones v. H.F. Ahmanson,* a minority stockholder in a savings and loan association brought a derivative action against a holding company formed by defendant majority stockholders and officers of the association. Essentially, the plaintiff contended that to take advantage of a bull market in savings and loan stock, the majority stockholders formed a holding company, transferring to it the control block of association stock in exchange for a considerably greater number of holding company shares, excluding the minority stockholders from participating therein, pledging the association's assets and earnings to secure the holding company's debt that had been incurred for their own benefit, and finally, having thus left the minority with stock whose potential market had been destroyed, using that very fact as a basis for offering to buy stock at an exchange rate less favorable than they themselves had enjoyed. In addition, the majority through the newly formed holding company caused the savings and loan association to cease paying dividends, other than the regular $4.00 per share annual dividend, although extra large dividends had previously been paid.

The California Supreme Court held that California no longer follows the rule recognizing the right of majority stockholders to dispose of their stock without the slightest regard to the wishes or knowledge of the minority. The prevailing rule is that of inherent fairness from the viewpoint of the corporation and of those interested therein, and majority stockholders may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority. The

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contract by failing to make any decision at all. The court read literally the agreement to conduct a binding arbitration, finding that the neutral's abandonment of the arbitration and continuation of the mediation constituted non-performance and was a narrow exception to the common law doctrine of arbitral immunity.

Interestingly, the court noted that this case was at the pleading stage before a full evidentiary picture has been developed, adding that if a neutral arbitrator were to state that the reason for withdrawal was because of a conflict of interest or a substantial doubt of their ability to be fair and impartial, he or she would have legal justification for immunity. (See Code Civ. Proc., §§ 1281.9, subd. (a); 170.1, subd. (a)(6)(B); Standard 6, Ethics Standards for Neutral Arbitrators in Contractual Arbitration, Appendix to Cal. Rule of Ct. (West Ann. Code 2005, Vol. 23, Pt. 4, p. 572), which require arbitrators to withdraw if they cannot maintain their impartiality. Therefore, an arbitrator's decision to withdraw based on ethical standards is, according to the court, integral to the arbitral function and covered by arbitral immunity.

Drafters of ADR clauses must now consider all the ramifications these new cases present. If a combination of dispute resolution procedures are to be used in the event of a dispute, provide language that clearly communicates the scope and breadth of the parties' agreement. This is particularly true when one neutral is to serve as both mediator and arbitrator.

The dicta in *Lindsay v. Lewandowski,* suggests that parties ought to think about whether facts presented in the mediation could be considered by the neutral making an arbitral decision. But mediation confidentiality statutes, Evidence Code section 1115 et seq. might not permit an arbitrator to accept evidence presented in a mediation for deliberation in an arbitral decision.

Consider also whether the neutral, acting as mediator and then arbitrator, may revert to a facilitative role before making binding adjudicative decision. If a binding arbitration decision had been provided in the *Morgan Phillips v. Jams/Endispute* case, one of the parties might still have alleged coercion and breach of contract, because the agreement apparently called only for arbitration of disputes arising out of the settlement agreement and not continued mediation.

These cases again demonstrate what happens when a dispute resolution agreement is unclear about the process. Drafters of customized dispute resolution agreements must make sure that their clauses exhibit informed consent and knowing waivers. Everyone must be on the same page regarding the dispute resolution mechanism well before any dispute arises. As these new cases once again display, afterwards is too late. ■

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to pick up email, that my client had sent all of the documents he had brought to me, along with some documents I had created, to another attorney.

I was only slightly less chagrinned to learn that this other attorney was not stealing away my new client, but was counsel for a potential investor the client had found. I would have preferred to have made initial contact myself, without having had several half-written agreements sent out to investor's counsel.

As I was sitting reading my other emails, an email came in from the investor's attorney: "Nina Yablok??? The same Nina Yablok with whom I served on the Business Law Section's Education Committee?" Note to the Young 'Uns: The Business Law News Editorial Board used to be called the Education Committee.

Well, I wrote back that not only was it the same person, but I was still lurking around the Business Law Section and was now about to embark on another year as Editor-in-Chief of the Business Law News, a fact my client didn't know, until then. And suddenly my client was wide-eyed with wonder and amazement that his little sole proprietor attorney was the Editor-in-Chief of the Business Law News (whatever that was) and was known and apparently respected by the investor's counsel.

I would hate to suggest that this sort of "PR" is the reason why attorneys should volunteer for Business Law Section Committees, and especially for the Business Law News Editorial Board. But… it couldn't hurt.

So with that coincidence, I started out in September of 2005. I didn't know then that the client I was working with would get funding and the work would seriously erode my available time, and along with that, some of my plans for the 2005-2006 Business Law News year.

Notwithstanding my time constraints, this year has seen some great articles, and a continued tradition of excellence in legal publications from the Business Law News Board. I would like to thank all of the Editorial Board members for doing a truly bang up job this year. And of course, thanks always goes to Megan Lynch, our indefatigable staff person, and to Susan Orloff, who holds the whole Section together.

This year we also started using the Beta version of the Bar's online workroom with some success. Perhaps I will be invited to write an article about it in an upcoming edition of the BLN.

The 2006-2007 year's Editor-in-Chief will be David Pike. I think the next few years are going to present a challenge to the Business Law News. As more and more attorneys become truly electronically focused for their legal research and communica-

tions, any "dead tree" journal will have to re-define itself and the benefits it brings to its readers. This is not to question that there are still significant benefits to hard copy journals, but only to point out that the relative roles of electronic versus paper forms of communication must be constantly evaluated.

Technology also makes it easier for attorneys to volunteer as committee and Editorial Board members. No longer are volunteers asked to travel between Northern and Southern California on a monthly basis. Meetings now occur by telephone, and even those meetings may become less frequent as the use of online collaborative tools increases.

This is a great time for younger attorneys to get involved with the Section. Editorial Board membership is open to a greater number of attorneys than is membership on other committees of the Section. I would urge all of you who've made it this far into this letter to consider applying for membership on the Editorial Board. It's a great way to stay on top of events in a wide area of business law. And who knows, you may some day get instant credibility when a client's investor's counsel remembers you from your days as a Business Law Section Volunteer. ■

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